

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:CTM:LN:POSTF-161303-01
JSHargis

date: February 26, 2002

to: Jerry Gossett, Appeals Officer, LMSB, Laguna Niguel

from: June Y. Bass, Associate Area Counsel (LMSB)
J. Scott Hargis, Senior Attorney (LMSB)

subject: Whether debt of which [REDACTED],
was relieved upon transfer of property was recourse or nonrecourse

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

ISSUE

Whether the debt from which the taxpayer was relieved of the obligation to pay upon transfer of the property to the creditor (which was also a partner along with the taxpayer in the partnership that had been holding the property) was recourse or nonrecourse for purposes of section 1001 of the Internal Revenue Code?

FACTS

[REDACTED] is a California Limited Partnership. [REDACTED] was itself a partner in a California general partnership, [REDACTED]. The other partner in [REDACTED] was [REDACTED] a California corporation owned by [REDACTED] Inc., another California corporation with [REDACTED] shareholders. [REDACTED] was formed when [REDACTED] and [REDACTED] entered into a joint venture agreement in [REDACTED] to construct, develop, lease and operate certain real property. On [REDACTED], [REDACTED] executed a note to [REDACTED] for \$[REDACTED]. [REDACTED] was to make monthly payments culminating in payment of any outstanding interest and principal on [REDACTED]. It is unknown what sort of financing was used by [REDACTED] between [REDACTED] and [REDACTED]. And, it is unknown what other financing [REDACTED] used simultaneously with the notes mentioned.

[REDACTED] also apparently gave [REDACTED] a series of short term notes. Two such notes, one for \$[REDACTED] payable after [REDACTED] days in [REDACTED] and [REDACTED] of [REDACTED] and one for \$[REDACTED] payable after [REDACTED] days in [REDACTED] and [REDACTED] of [REDACTED], were included in the request

for advice. Counsel has not been apprised of the nature and purposes of these short term notes nor of the existence of any others--such as for the period between [REDACTED] and [REDACTED]. Our analysis is confined to the notes actually submitted and it should not be assumed that other obligations should be treated in the same manner.

As a result of disagreement between the parties, [REDACTED] offered to purchase [REDACTED]'s interest in [REDACTED] during [REDACTED]. It is not known when these disagreements arose--i.e., before or after the execution of the \$ [REDACTED] note on [REDACTED]. Nor is the nature and substance of the disagreements known.

The purchase of [REDACTED]'s interest in [REDACTED] by [REDACTED] was structured as a dissolution of the joint venture, followed by a distribution of the property to the partners, followed by a sale of [REDACTED]'s interest in the property to [REDACTED].¹ At the time, [REDACTED] had a [REDACTED]% interest in the joint venture.

Based on the provisions of the Joint Venture Agreement, it appears that [REDACTED] originally contributed the property that was to be the [REDACTED] subject to unknown obligations, some of which were to be assumed by the partnership and some of which were not. Joint Venture Agreement paragraph [REDACTED]. The Agreement also contemplated that the partnership would obtain construction financing up to \$ [REDACTED] from a third party or [REDACTED] or an affiliate of [REDACTED]. Joint Venture Agreement paragraph [REDACTED].

On [REDACTED], [REDACTED] entered into three separate sale agreements with [REDACTED] for the assets that made up [REDACTED]'s [REDACTED]% of the former partnership property. As payment for the property, [REDACTED] relieved the taxpayer of its share of the debts and encumbrances to which the property was subject as of [REDACTED]. The request for advice represents that the notes attached to the request are representative of the ones for which [REDACTED] received relief upon the sale. The notes appear to be straightforward promises to pay and do not contain exculpatory

¹ No advice has been requested regarding the ramifications of the partnership dissolution, thus none is offered. We note that it is not state law dissolutions that determine tax consequences but rather terminations under I.R.C. § 708, which are not the same as dissolutions. Section 708(b)(1)(A) and Treas. Reg. § 1.708-1(b)(1) provide that a partnership shall terminate when the operations of the partnership are discontinued and no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership. Treas. Reg. § 1.708-1(b)(1) states that when a partner in a partnership purchases the interests of all of the other partners, the partnership terminates under section 708(b)(1)(A). As [REDACTED] purchased all of [REDACTED]'s interest in the former partnership assets, the transaction would appear to be a termination under I.R.C. § 708. See also Rev. Rul. 99-6, 1999-1 C.B. 432 (discussing the consequences of buyouts of partnership interests that result in termination.) Given the other provisions of subchapter K that would apply to this transaction, however, we suggest that you request advice regarding an analysis of this transaction as a partnership termination under subchapter K.

clauses that might prevent [REDACTED] as creditor, from obtaining a deficiency judgment against [REDACTED].

On the same day that the property was transferred, [REDACTED], [REDACTED] and [REDACTED] entered into a Cross-Indemnity and Release Agreement. This Release Agreement was intended to settle all claims between the partners relating to their prior dealings, except those relating to continuing leases and to the other agreements executed at the same time as the Release Agreement. In the Release Agreement [REDACTED] agreed to indemnify [REDACTED] for California sales and use taxes, documentary transfer tax, and withholding under section 1445 of the Code (or similar state law provision) and other expenses related to these taxes that would be incurred to transfer property pursuant to the dissolution. [REDACTED] also promised to indemnify [REDACTED] for liabilities resulting from a determination that [REDACTED]'s election out of subchapter K was invalid.² Finally, [REDACTED] agreed to indemnify [REDACTED] and [REDACTED] for any liabilities contracted or incurred by [REDACTED] that could be charged to [REDACTED] or [REDACTED] that had not been disclosed in writing.

On [REDACTED]'s part, the Release Agreement provides

a. [REDACTED]

Thereby apparently forgiving the debt owed by [REDACTED] on the note. The Release Agreement

² The facts presented indicate the election could not have been valid. Such an election can only be availed of by investment partnerships, partnerships for the production, extraction or use of property (but not for the purpose of selling services or property produced or extracted), or by dealers in securities for the purpose of underwriting, selling, or distributing a particular issue of securities. Section 761. None of these descriptions apply. [REDACTED] was to develop and operate rental real estate. It was not a passive or temporary investment vehicle but an entity created to hold an active business.

goes on to provide that the parties release each other from all other claims not mentioned or otherwise agreed to continue.

DISCUSSION

A property transfer to a creditor in satisfaction of a debt is a sale or exchange on which gain or loss is realized. See, e.g., U.S. v. Davis, 370 U.S. 65, 8 L.Ed.2d 335, 82 S.Ct. 1190 (1962); Bialock v. Commissioner, 35 T.C. 649 (1961). As with foreclosures, the amount realized depends upon whether the debt satisfied by the transfer is recourse or nonrecourse. If the loan is nonrecourse, the full amount of remaining debt is the amount realized, even if debt exceeds value. Commissioner v. Tufts, 461 U.S. 300 (1983); Estate of Delman v. Commissioner, 73 T.C. 15 (1979). If the debt is recourse, the amount realized is the property's fair market value. See also Treas. Reg. § 1.1001-2(c), Ex. 7 & 8. The resulting gain is not income from the discharge of debt under I.R.C. § 61(a)(12) and, therefore, is not excludable from income even though the debtor was insolvent at the time the property was transferred. If the recourse debt satisfied exceeds the property's fair market value, the excess is debt discharge income which may be excludable under I.R.C. § 108(a). Danenberg v. Commissioner, 73 T.C. 370 (1979).

Generally, a recourse obligation is one for which the debtor is personally liable, that is, the creditor may have recourse against the debtor if the security is not sufficient to pay the debt. The task of classifying an obligation as recourse or nonrecourse for Federal tax purposes generally requires an examination of all the facts and circumstances with the legal rights and obligations of the parties determined under applicable state law. There are several Code sections under which the issue of debt classification as recourse or nonrecourse most frequently arise.

For partnership liabilities, § 752 is the applicable statute.³ Treas. Reg. § 1.752-1(a)(1) defines recourse liability as follows, "A partnership liability is a recourse liability to the extent that any partner or related person bears the economic risk of loss set forth under T.R. 1.752-2." Treas. Reg. § 1.752-1(a)(2) defines nonrecourse liability similarly, "A partnership liability is a nonrecourse liability to the extent that no partner or related person bears economic risk of loss for that liability under T.R. 1.752-2." "T.R. 1.752-2" or Treas. Reg. § 1.752-2 provides for an analysis based on a "constructive liquidation" in which all of the partnership's liabilities become due and payable and all of its assets are sold in taxable transactions for no consideration. This bleak scenario removes the barriers of time and partnership assets and income from between the partners and the liabilities. Once those barriers are removed, one can see which partners would actually have to reach into their pockets to pay off the debts and the extent to which they would have to do so.

If a liability is recourse, then it will be allocated to and includible in the basis of the partner who bears the ultimate burden of repayment, i.e., a partner who is obligated to satisfy a creditor or to make a contribution to the partnership with respect to the partnership liability in the event that the partnership is unable to satisfy the liability. The key here is the concept of

³ For individuals and C corporations, I.R.C. § 465 may be applicable.

"ultimate" liability--the responsibility that falls on a partner who is the obligor of last resort and who has no right to reimbursement from or recourse against any other partner (or related person) or the partnership. Under this approach, a partner bears the risk of loss to the extent that he is responsible to discharge a partnership liability if the partnership is unable to do so.


Under I.R.C. § 752 analysis, [REDACTED] would be liable for the debt under the facts presented without recourse to other obligors for indemnification or contribution. Should the property suddenly become worthless, [REDACTED] would be liable for its pro rata share of the debt. No evidence has been presented to indicate that there is an agreement between the parties that prevents [REDACTED] as creditor from securing a deficiency judgment should the collateral prove inadequate.

Section 580d of the California Civil Code provides:

No judgment shall be rendered for any deficiency upon a note secured by a deed of trust or mortgage upon real property or an estate for years therein hereafter executed in any case in which the real property or estate for years therein has been sold by the mortgagee or trustee under power of sale contained in the mortgage or deed of trust.

This effectively limits the power of creditors to seek deficiency judgments in certain situations. The deed of trust provided to counsel incorporates 14 paragraphs by reference from a fictitious deed of trust filed in numerous California counties in 1961. It is not known if these incorporated paragraphs contain such a power of sale.

Regardless of the existence of such a power, the facts as presented are that the disposition of the property was not made under any such power but rather was concluded by a direct sale from debtor to creditor in exchange for debt relief. Nor would such a clause and its use seem relevant because the creditor would have the power to choose whether to use it. It is also the creditor that decides whether to forgive the remaining debt. If a creditor has chosen to forgive the remaining debt, as was done here, the use of such a power of sale--with its attendant extinguishment of liability--would add nothing new to the analysis. , (b)(5)(AC)



CONCLUSION

On the facts presented the liabilities appear to have been recourse. We believe, however, that an analysis of this transaction under subchapter K should be undertaken and we suggest that

you resubmit the transaction and request advice on those issues. This advice has been coordinated with the national office. If you have any further questions or concerns, please contact the undersigned at (949) 360-3435.

J. SCOTT HARGIS
Senior Attorney